# SHREDDED REPUTATION: CONTAGIOUS EFFECT ON ANDERSEN'S CLIENTS IN MALAYSIA

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## ABSTRACT

This study examines the impact of Andersen reputation on market prices based on the event of Andersen admission of shredding documents related to the Enron audit in United States. Specifically, in this paper, we extend to the other stock exchange out of United States, namely Bursa Malaysia. Is there any contagious impact on Andersen reputation to the Bursa Malaysia? Since the admission announcement shows the issue of independence as the main focus in the Andersen case, this study also document the impact of non-audit fees on market reaction surrounding the admission announcement date. Interestingly, the results prevails a contagious impact on Andersen's Malaysia office due to the shredded reputation in the United States. However, Andersen's Malaysia office only suffered a less severe decline compared to Andersen's United States and Houston office. In addition, there is no evidence that Andersen's Malaysia independence was questionable.

*Keywords:* *Auditor Reputation, Auditor Independence, Market Prices*

## INTRODUCTION

Studies on auditor reputation have been discussed frequently in the accounting and auditing literatures. Such studies attempted to relate the audit reputation with audit fees, loan pricing and initial public offering (see for example, Francis and Simon, 1987; Betty, 1989; Butterworth and Houghton, 1995; Rose, 1999; Hartini, 2003). In addition, it is assumed that a reputable auditor also an independence auditor (De Angelo, 1981). Many people assume that larger audit firms, especially the Big Five firms, are more credible than the non-Big Five firms. Thus, they are presumed to perform more quality works than the non-Big Five. This phenomenon pretends to give value added to the wealth of companies.

However, recently the Enron scandal in the United States caused the reputation and independence of the Big Five to be questionable. The history event happened when the Enron's auditor, Andersen, was heavily criticized for its collapse. After August 2002, Andersen was barred from conducting and reporting on the audits of SEC-registered companies. This is never happens in the history of auditing profession that such big firms are denied of its quality in that way.

The Enron case caused the auditor's reputation severely tarnish to the extent that many companies' (Andersen's clients) share prices significantly dropped simply because investors loss confidence on the auditor's reports (Chaney and Philipich, 2002). However, Andersen (also known as Arthur Andersen) was a multinational audit firms. The events occurred in the U.S may contagious to other nations due to the shredded reputation in the United States. Nevertheless, empirical study has to be carried out to confirm such contention. This paper attempts to carry out such study.

## LITERATURE REVIEW

There were a lot of previous studies that addressed the issue of audit quality for large audit firms. It is suggested that large audit firms produce higher audit quality than the smaller audit firms (Lennox, 1999). Such qualities are recognized as market react positively when a company switches to a larger audit firms from a smaller one (Nicholas and Smith, 1983).

Menon and Williams (1994) found that the disclosure of L&H's bankruptcy had an adverse effect on market prices of L&H clients. He used seasoned securities and initial public offering (IPO) loss as the determinant of Cumulative Abnormal Return (CAR). In addition, Green and Dawkins (2000) found that there was negative association between bankruptcy outcome and price reaction to bankruptcy filings.

Similarly, Moreland (1995) in his study of the effects of SEC criticisms (sanctions) of auditors on earning response coefficients (ERC) of client firms, found that abnormal security returns is negatively affected by earning prices. This is also supported by study by Firth (1990) who found that United Kingdom of Trade (DOT) investigations into the affairs of a specific company and their criticism on the auditors appear to incur economic losses from the damage of their reputations.

A further study by Chaney and Philipich (2002) using Andersen's client shows that the cost of audit failure would affect and impaired audit reputation. The results show that on the three following days after Andersen's admission of a significant number of documents had been shredded; the Andersen's clients experienced a statistically negative market reaction. This suggested that investors downgraded the quality of audits performed by Andersen (Chaney and Philipich, 2002). Besides, they also found that the clients whose audit was performed by Andersen's Houston office suffered a more severe decline in abnormal returns on this date. Similarly Krishnamurthy, Zhou and Zhou (2002) found that the deterioration of Andersen's reputation was the worse after its criminal indictment on March 14, 2002 caused the market to react more negatively to Andersen clients than to clients of the other Big Four auditors.

Besides concentrating and analyzing the effect of auditor reputation on market reaction of Andersen's clients, Chaney and Philipich (2002); Krishnamurthy *et al.* (2002) studied on the impact of non-audit services to the market prices. It is presumed that market react negatively to the larger non-audit services purchased by Andersen's clients, which show that the auditor independence is impaired (Chaney and Philipich, 2002; and Krishnamurthy *et al.*, 2002). However the results are mixed. Krishnamurthy *et al.* (2002) found that the abnormal return is significantly higher when auditor independence is perceived to be high. This is contrast to Chaney and Philipich (2002). The reason why this happens is because Krishnamurthy *et al.* (2002) used the date of Andersen criminal indictment on March 14, 2002 while Chaney and Philipich (2002) focused on the date of Andersen's admission that a significant number of documents had been shredded. Also, Chaney and Philipich (2002) uses sample which consisted relatively larger firms, whereas Krishnamurthy *et al.* (2002) sample consisted of many smaller firms. However, in general, both studies confirm that Andersen reputation was declined even different dates were used in their analysis. Therefore in this study, the date of Andersen's admission that a significant number of documents had been shredded will be analyzed using the regression analysis to ensure that the results can be concluded clearly.

## HYPOTHESES DEVELOPMENT

The role of an auditor is to monitor a company. The monitoring mechanism is to ensure that managers act in accordance with owners' interests or to reduce agency costs such as increasing rate of managers' honest reporting and reduce the auditing demand by the owner (Chow, 1982; and Finley, Hopwood and Tucker, 1999). In addition, the reputation effect of an auditor will control the opportunistic value-reducing behaviour of the managers (Fama, 1980). This would happen in efficient competitive market (Fama, 1980). Thus, such reputation will protect the share price by adjusting the share prices accordingly (Watts and Zimmerman, 1986). In fact, the managers demand such quality of auditor to signal their honesty to the market (Jensen and Meckling, 1976). Subsequently, the last resort is to protect the shareholder interest. However, when an audit firm is in the case of uncertainty such as bankruptcy or lawsuits, the companies will together bear this uncertainty. As suggested by Menon and Williams (1994), this situation will lead to future monitoring uncertainty and the prospect of a delay in the filing of audited financial statements. Both may create possible losses to the companies such as negative reaction of stock prices.

In the light of the Andersen's Malaysia case, the negative market reaction might not be seen before the announcement of Enron's bankruptcy because probably investors in Malaysia still did not know this news. In fact, the contagious effect would not happen before a bad news is announced. The brand name of Andersen was tarnished around the world after Andersen admitted shredded the Enron's documents. Later, such brand name has not been used outside the United States after Andersen United States was barred from auditing the companies. They then tried to find other Big Four for merging and building a reputable brand name. The brand name and audit quality represent the reputation of the auditor and is the most important feature of an audit firm (Dopuch and Simunic, 1982). A repetition story of Andersen failure in the news and press worldwide may also portray an eroded reputation because an action was called to be taken to the Andersen by outsiders such as Securities Commission and public. We argued that it may results the investors outside United States to pull out the investment in Andersen clients.

Evidence shows that deterioration in the audit quality of Andersen occurred no later than mid-1990s compared to other Big-Five (Fuerman, 2003). What would happen that Andersen could not protect their liability from any legal regime in the world when the consequence of audit quality and audit failure were severe after they admitted shredded the documents even though Andersen was assumed providing a high audit quality to their clients (Kadous, 2000). Again, we expect that the Andersen United States reputation will also effect the reputation of Andersen worldwide specifically Andersen Malaysia, hence, reflecting negatively in the share prices of its clients.

Study by Callen and Morel (2002) proved that events directly related to Andersen had a larger (negative) impact on stock returns than events directly related to Enron. Therefore, in the case of events directly related to Andersen, it is expected that a negative reaction will be prevailed. In this present study, one event directly related to Andersen' United States that might be effect other Andersen around the world including Malaysia is studied. The date used is the announcement of shredding documents, which Andersen had admitted on Jan 10, 2002. This announcement is the bad news to Andersen's clients. Event on Jan 10, 2002 was unexpected and was met with shock in the business community due to the fact that normally when audit firms paid damages to lawsuit claimants or penalties to the SEC, they are careful not to admit guilty (Chaney and Philipich, 2002). Subsequently, this will tarnish the Andersen reputation. As a result of the bad news, the Andersen's clients also affected. It is argued that the contagious impact will happen in Malaysia due to the fact that Malaysia is an open market nation and Andersen established its branches over here. However, the contagious impact would not spread to other Big Four because it only involved Andersen's reputation (Krishnamurthy *et al.*, 2002). Therefore the following hypotheses are derived as follows (in alternate form):

*H1a:* *Andersen's clients in Malaysia will experience a negative market reaction to the announcement of news that Andersen admitted shredded documents related to the Enron audit, is made public.*

*H1b:* *Andersen's clients in Malaysia will experience a negative market reaction to the announcement of news that reflects negatively on the Andersen's reputation.*

In addition, the negative abnormal returns could be driven by the Andersen independence. It is argued that audit firms provided other services rather the audits to some extend impair their independence. In the Andersen's case, the event that Andersen admitted shredded documents related to the Enron audit are likely impaired Andersen independence. This will be more prominent if Andersen perform more on other services rather than audit services. As the consequences, the reliability and validity of Andersen audit of their companies could be denied and questionable. Investors will belief that Andersen did not give the best opinion as "true and fair view" to their clients. Thus, the negative abnormal return would be larger if the auditor independence perceived to be impaired.

H2: *There is a positive relationship between audit fee ratio and abnormal return for events that perceived Andersen not to be independence.*

Consistent with the measurement used by Krishnamurthy *et al.* (2002), the measurement of Andersen independence is the ratio of audit fees to total fees. The reason this measurement is used because low audit fee ratio shows that the auditors provide large amounts of non-audit services, and therefore perceived to be not independent (Krishnamurthy *et al.* 2002).

## METHODOLOGY

The sample comprised of all Andersen's clients in Malaysia in the year of 2000 and must still maintain engagement with Andersen until 2002. Total sample is 101 companies. For descriptive analysis, the date that Andersen admitted shredding the documents on January 10, 2002 is used. Ten trading days on stock prices of Bursa Malaysia (Main and Second board) are gathered (see Menon and Williams 1994).

This study used previous established event study model. Fama, Fisher, Jensen and Roll (1969) pioneered the event study. Later, in 1980s, the researchers introduced the cross sectional studies using abnormal returns and firm specific variables of size and leverage (see Leftwich, 1981). Thus, this study replicates the established model of cumulative abnormal return from previous studies in market reaction of audit quality that is used worldwide in auditing literature (see for example, Menon and Williams, 1994; Chaney and Philipich, 2002; Krishnamurthy *et al.*, 2002 in the United States; and in Asia, Gul, Sun and Tsui, 2003) and extended to accommodate the Malaysian environment. Several variables such as size and risk are control in the Ordinary Least Squares Regressions, are possible to influence market returns (see for example Menon and Williams, 1994; Chaney and Philipich, 2002; and Krishnamurthy *et al.*, 2002 in the United States; and in Asia Gul, Sun and Tsui, 2003). Both variables are well specified in the model (Leftwich, 1981). Size and risk are proxied by the natural log of total assets and debt/total assets ratio (debt ratio). Size and risk provide a simple and powerful characterization of abnormal return in finance literature (Banz, 1981; and Fama and French, 1992). Both variables are powerful variables to explain Cumulative Average Return (CARs). Other variables ;sales growth

(SALESGROW), Andersen (AA) and financial year-end (FYR) are most likely to attribute the price movements within the window period, thus, affect the market return (Menon and Williams, 1994; Chaney and Philipich, 2002; and Krishnamurthy *et al.,* 2002 in the United States; and in Asia Gul, Sun and Tsui, 2003). Below are the detailed explanations of each variable that likely attribute the price movements within the window period, which may attribute to the contagious effects.

This study uses one sample t-test and the regression analysis (OLS) to analyze the data. The research models are as follows:

Andersen admitted shredding documents

$$CAR = \alpha + \beta_1 FEERATIO + \beta_2 LOGASSETS + \beta_3 SALESGROW + \beta_4 LEV + \beta_5 AA + \beta_6 FYR + e$$

where,

CAR= The Cumulative Mean Abnormal Return for Andersen client over the two, three and five days around admitted of shredding documents by Andersen.

$$CAR \quad \sum_{t=0}^{T} AR_{it}$$

where,

$$AR_{it} = R_{it} - (\alpha + \beta_i R_{mt})$$

$AR_{it}$ = Abnormal Return
$R_{it}$ = Observed return on security I
$R_{mt}$ = Return on the KLSE Composite Index (KLCI) for the $t$ th period
$\alpha$ = Intercept
$\beta_i$ = Beta for firm $I$[1]
FEERATIO = The ratio of audit fee to total fees paid to Andersen
LOGASSETS = $Log_{10}$ of total assets
SALESGROW = Percentage growth in sales from 19999-2000
LEV =The ratio of long-term debt plus short-term debt to total assets
AA =Indicator variable having a value of 1, if the name of auditor is Andersen and 0, if Hanafiah Raslan Mohamad
FYR =Indicator variable having a value of 1, if the fiscal year-end between December 31 and January 31, and 0, if otherwise
$\alpha$ = constant (i = 0)
$\beta$ = Coefficients= i = 1,2,3,4,5

## RESULTS

### Descriptive Analysis

Table 1 shows that how the sample is gathered. As suggested by Menon and Williams (1994), the companies must meet all the following criteria; first, the companies should have stock return data. Second, additional data in the analyses should be available; third, the trading price should at least RM0.25, and lastly, the companies should not make a dividend or earnings announcement on the ten trading days. In addition, all Practice Note 4 companies are eliminated to ensure no compounded effect and also meet the Menon and Williams (1994) requirements.

[1] Betas were estimated using a 100-day estimation period that ended December 31, 2001 (refer to Menon and Williams, 1994). Composite Index of Bursa Malaysia was used to compute market returns.

Table 1: Sample Selection: Andersen's clients in Bursa Malaysia

| | |
|---|---|
| Total Andersen's Clients | 154 |
| *Less* | |
| Delisting companies | 3 |
| Practice Note 4 companies | 32 |
| Earning Announcement | 3 |
| Dividend Announcement | 5 |
| No Return Data | 6 |
| No Annual Report | 1 |
| Trading price below RM0.25 | 3 |
| **Total Sample** | **101** |
| Companies that purchased Non-Audit Services (NAS) | 28 |
| Companies that did not purchase NAS and disclose it in the annual reports | 26 |
| Total Sample for regression analyses | 54 |
| Companies that are silent on NAS (assumed did not purchase NAS) | 47 |
| **Total sample** | **101** |

Table 2 and Table 3 confirms that CARs for Andersen clients are significantly negative for two and three event windows. However, both abnormal returns and CARs are less severe compare to Andersen's counterpart in United States and Houston (see Chaney and Philipich, 2002). For example, on January 11 average abnormal returns for Andersen's clients in Malaysia are only -.3547 % compare to Andersen's clients in United States with –0.78%. Similarly, in Malaysia, CAR for two event windows (0, +1) is only –.7043%, while United States and Houston office are –1.17% and –3.16% respectively. Again, it is shows that Andersen's Malaysia office is less severe decline on this date. Overall, the results from Table 2 and Table 3 support Hypothesis 1 (1a and 1b).

Table 2: Effect of Andersen Admitted Announcement of Shredded Documents on Security Prices of Andersen Clients in Malaysia-Abnormal Returns for Ten days Around Disclosure Period

| Date | Average Abnormal Return (%) | t-test |
|---|---|---|
| Jan 7 | -0.3366 | -1.593 |
| Jan 8 | -0.3603 | -1.7* |
| Jan 9 | -0.3148 | -1.493 |
| Jan 10 | -0.3496 | -1.647 |
| Jan 11 | -0.3547 | -1.676* |
| Jan 14 | -0.3674 | -1.730* |
| Jan 15 | -0.3609 | -1.704* |
| Jan 16 | -0.3624 | -1.711* |
| Jan 17 | -0.3506 | -1.654 |
| Jan 18 | -0.3516 | -1.654 |

* Significant at 10% (2-tailed)

Table 3: Effect of Andersen Admitted Announcement of Shredded Documents on Security Prices of Andersen Clients in Malaysia- Cumulative Abnormal Returns (CARs)

| Event Window | Cumulative Abnormal Return (%) | t-test |
|---|---|---|
| (0, +1) | -.7043 | -1.664* |
| (0, +2) | -1.0717 | -1.686* |

* Significant at 10% (2-tailed)

**Multivariate Regression Analysis**

Before using multivariate regression analysis, an analysis on multicollinerity was done. Table 4 shows that only LEV and LOGASSETS is positively associated at 0.01 levels. However, the coefficient between both variables is still acceptable (0.518). To ensure the multicollinerity does not pose serious problem to the multivariate regression analysis, variance inflation factors (VIF) are computed. Evidence exhibits that VIF are under 2. Therefore, it indicates that the multivariate regression analyses can be used to test the Hypothesis 2 with minimal multicollinerity problems.

The purpose to use the mutivariate regression analysis is to test Hypothesis 2. If Hypothesis 2 is true, the issues of auditor independence, specifically Andersen's Malaysia must be worried. However, the results from Table 5 do not support Hypothesis 2 for both event windows (two-day-window and three-day window). FEERATIO is insignificant although the sign is positive as expected.

The coefficients for other variables are in the expected directions. However, only two variables are significant. AA and FYR have significantly negative associated to CARs at 0.05 levels (two-tailed test). AA is introduced in the analysis because Andersen was team up with the largest local audit firm of Hanafiah Raslan Mohamad (HRM). The market of audit firm in Malaysia is unique because most of the Big Five team up with local audit firm. Therefore, it is assumed that Andersen is more reputable compared to HRM but not after the shredded document scandal. This might due to the fact that international investors foresee the Andersen quality downgraded after the admission announcement of shredded document by Andersen. The negative coefficient confirms this contention. The variable FYR has a significantly negative coefficient and consistent with Menon Menon and Williams (1994).

The regression analysis of the two-day window does not much different with the three-day window. Adjusted $R^2$ for both event windows are 0.129 and 0.129, respectively, which is comparable with other studies (refer to Menon and Williams, 1994; Chaney and Philipich, 2002; Krishnamurthy *et al.*, 2002). Besides, both models are significant at 0.049 and 0.051. Further tests are also employed and the results still hold.[2]

The results should be interpreted cautiously due to the fact that the declining share prices of Andersen's clients might not be solely necessarily because of the event involved with the shredded reputation of Andersen in United States. The results might be clearer if we include non-Andersen clients as a control sample. However, due to unavoidable constraints, an analysis on the non-Andersen clients could not be conducted.

There are two kinds of results that will be revealed for non-Andersen clients. First if the abnormal return and cumulative abnormal return for their clients are not significant, it shows clearly about the contagious effect. However, if the results are significant and similar with Andersen's clients, it shows that it is congruent with the efficient market hypothesis. Evidence reveals that the investors in Malaysia market follow the market sentiments (Noor and Wan, 2004). Thus, this gives a significant impact on non-Andersen clients because of the investors are so panic about the event happened in United States and the heavily criticisms on the audit quality of auditors including Big Five firms after the scandal involved Andersen.

Although the research design does have such constraints, this study still provides some empirical evidence on insurance hypothesis theory using the stock prices. In fact, contagious effects can be expanded to other countries. There is some evidence shows that Andersen Malaysia reputation also affected by the shredded reputation of Andersen US. But, in the case of Andersen Malaysia independence, there is no evidence that investors react negatively when Andersen Malaysia providing large non-audit services to their clients.

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[2] The non-audit fees ratios are used to replace audit fees ratios and the results still similar.

Table 4: Correlation Matrix between Independent Variables

| | FEERATIO | LOGASSETS | SALESGROW | LEV | AA | FYR |
|---|---|---|---|---|---|---|
| FEERATIO | 1 | .144 | -.161 | .041 | .027 | -.126 |
| LOGASSETS | .144 | 1 | -.056 | .518(***) | -.117 | -.014 |
| SALESGROW | -.161 | -.056 | 1 | -.075 | .056 | .007 |
| LEV | .041 | .518(**) | -.075 | 1 | -.154 | .038 |
| AA | .027 | -.117 | .056 | -.154 | 1 | .162 |
| FYR | -.126 | -.014 | .007 | .038 | .162 | 1 |

*** Correlation is significant at 1% (two-tailed).

Table 5: Effect of Andersen Admitted Announcement of Shredded Documents on Security Prices of Andersen Clients in Malaysia- Regression of Cumulative Abnormal Returns (CARs), N=54

| Variables | Expected Sign | Two-day window | | Three-day window | |
|---|---|---|---|---|---|
| | | Coefficient | *t*-statistic | Coefficient | *t*-statistic |
| FEERATIO | + | .123 | 0.924 | .122 | 0.918 |
| LOGASSETS | - | -.011 | -0.073 | -.009 | -0.061 |
| SALESGROW | - | -.159 | -1.217 | -.158 | -1.211 |
| LEV | - | -.026 | -0.169 | -.026 | -0.171 |
| AA | - | -.266 | -2.012** | -.266 | -2.013** |
| FYR | - | -.278 | -2.114** | -.276 | -2.098** |
| Constant | +/- | | 0.122 | | .1090 |
| Adjusted $R^2$ | | 0.129 | | 0.128 | |
| F ratio | | 2.310 | | 2.292 | |
| Prob > F (Two-tailed test) | | 0.049 | | 0.051 | |

** Significant at 5% (2-tailed)

***Variable description:***

| | | |
|---|---|---|
| FEERATIO | = | The ratio of audit fee to total fees paid to Andersen |
| LOGASSETS | = | $Log_{10}$ of total assets |
| SALESGROW | = | Percentage growth in sales from 19999-2000 |
| LEV | = | The ratio of long-term debt plus short-term debt to total assets |
| AA | = | Indicator variable having a value of 1, if the name of auditor is Andersen and 0, if Hanafiah Raslan Mohamad |
| FYR | = | Indicator variable having a value of 1, if the fiscal year-end between December 31 and January 31, and 0, if otherwise |

## IMPLICATIONS, LIMITATIONS AND CONCLUDING REMARKS

This study provides evidences that Andersen's clients in Malaysia also react negatively with the issue of Andersen independence in the United States. These results should be interpreted with cautious because this doesn't mean that Andersen Malaysia was not independence. Malaysia market depends on United States thus what has happened in the United States would also impact Malaysia. In this study, the results show that a contagious impact on Andersen clients in Malaysia after what has happened in the United States.

Some implications should be emphasized. The interests of the local investors need to be protected whenever event of audit scandals occur abroad and has no connection with the local market. Thus, policy makers should take a drastic step to ensure the independence of audit firms in Malaysia are not compromised because the investors have to bear the risk if the auditor independence is impaired. For example, recently Malaysian Institute of Accountants (MIA) has revised the MIA By Laws (on Professional Independence) and came into force starting July 2004.

These findings are subject to several limitations. First, in terms of method, only one method was employed (one sample t-test). Results might be different if other methods such as corrected version of the Z-test is used. Second, the results for both abnormal return and cumulative abnormal return are weak with significant level at only 10%. Lastly, this study does not control non-Andersen clients due to unavoidable constraints. Future research should emphasize and include this in the analysis, to ensure the clearer picture about the auditor reputation on market prices.

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